19

Robert [redacted]
From: Bob SPEIR [Bob SPEIR at po-03] on behalf of Bob SPEIR
Sent: Tuesday, July 15, 1997 2:12 PM
To: John Northington
Subject: Re[3]: Oil Valuation

I will try.

____________________ Reply Separator ____________________

Subject: Re[2]: Oil Valuation
Author: John Northington at CP-01
Date: 7/15/97 2:00 PM

Bob:

Thanks for the update. I'm inclined to agree with your observations about hindreing the state's efforts at settlements with the companies. Keep me posted. Kyle is leaving for Moscow at the end of the week and I want to have a decision made on whether to comment or not before he leaves. Deadline for public comment is August 2nd I believe. Can you have something to me tomorrow p.m.?

John

____________________ Reply Separator ____________________

Subject: Re: Oil Valuation
Author: Bob SPEIR at po-03
Date: 7/15/97 12:46 PM

Have not written anything up yet because I have not fully digested the changes between the "Proposed Rule" regs of January 24 and the "Supplementary Proposed Rule" recently issued. My initial feeling is that MMS went too far in absolving companies from payment under the imputed market price rule when oil is exchanged.

I have gone a little farther by way of talking to some State people about actions they are taking. It seems that Bob Armstrong may be hearing from Gary Mauro about Texas's negotiations with Chevron. Other actions are underway in New Mexico (settlements already accomplished with Arco and Texaco), Louisiana, and Montana (in addition to Alabama, which we discussed earlier). Morris Leiry from New Mexico indicated that the royalty valuation issue will be a topic of discussion at the Western States Land Commissioners' meeting in North Dakota in two weeks.

My overall impression is that the States are having some degree of success getting the larger companies to pay up and/or agree to market based valuation for royalty oil. It seems that if DOE weighs in on behalf of oil producers and against MMS's new regs, we may disrupt activities States currently have underway. This adds to my overall concern about our involvement.

____________________ Reply Separator ____________________

Subject: Oil Valuation
Author: John Northington at CP-01
Date: 7/15/97 10:52 AM

Per our conversation last week, got anything ready for me to look at yet?

John
6-5065

[redacted]

From: Bob SPEIR [Bob SPEIR at po-03] on behalf of Bob SPEIR
Sent: Friday, July 18, 1997 7:18 AM
To: JOHN NORTHINGTON
Cc: JOHN PYRDOL; Carmen DIFIGLIO; Gay LESLIE
Subject: MMS Royalty Regulations

regcomnt.

John,

Again my apologies for being so late on this; the RPPR report intruded. I think it lays out my arguments pretty well. A lot more could be said and shown quantitatively, but this may be too much.

Paper copy follows. Use as you wish.

20

MEMORANDUM FOR: KYLE SIMPSON

THROUGH: JOHN NORTHINGTON

FROM: ROBERT A. SPEIR

SUBJECT: DOE Comments on Minerals Management Service's Proposed Royalty Regulations

This is in response to John Northington's request to provide an interpretation of the issues stemming from MMS's recent changes to its proposed rewrite of its federal oil royalty regulations. As you may recall, I represented DOE in the two-year evaluation of royalty underpayments in California. That study's findings led MMS to conclude that it must revise its regulations.

Over the past few months, oil producers' associations and their members repeatedly have encouraged DOE to submit negative comments to the Department of Interior on MMS's proposed revision of its federal oil royalty regulations. The associations have offered their own "revised" regulations that are, upon inspection, only slightly altered from the current regulations.

My recommendation remains that DOE not comment on the proposed regs. This is, I believe, a logical compromise between our duty to the taxpayer and DOE's close association with the oil producing industry. On one hand I believe that DOE should support MMS's attempts to get fairer taxpayer value from its oil leases. On the other, positive comments will antagonize independent oil producers--which DOE has traditionally viewed as its primary constituency in the oil industry. I recommend the no-comment strategy with increasing reluctance. MMS's latest changes to the proposed regulations probably leave loopholes, and some say that the staff is not firmly behind the changes. Together, these observations suggest that MMS is weakening under the industry onslaught and may need to be propped up by another cabinet agency.

It has appeared from the start that the independents, in taking the forefront of the lobbying attack on MMS's initiative, are acting in large part on behalf of the large integrated refiner-producers. Recently it has become evident that the larger independents oppose the new MMS regs for the same reason as the large integrated producer-refiners. That is, just like the majors, a number of independents pay federal oil royalties based on a valuation that is less than what they get for it in sales or exchanges. The new regs would make this difficult. The industry's response to MMS's proposed regs indicates that this is the only real issue in the rewrite of the MMS regs; virtually all the remaining industry arguments are just smoke.

The companies have devoted a major lobbying effort to attacking use of the NYMEX futures contract as a market index, at the same time they were acting to compromise its accuracy. As an integral part of the effort against the new regulations, the companies blocked at the Office of Management and Budget (OMB) MMS's attempts to clear an information gathering form on market price differentials. Concurrently, but in different venues (e.g., at DOE), they argued that oil valuation using market indices cannot work because MMS cannot reliably determine market price differentials. Since they have not proposed a viable alternative, one can only conclude that the attack on the NYMEX price index is largely a sham, and that the companies' primary objection is paying royalties on their real receipts.

In effect, the independent producers' complaints about the "duty to market" language in MMS's regulations have substantially confirmed that they are receiving higher revenues through their trading activities than they use as a basis for computing and paying federal royalties. They say that the "duty to market" concept is new and permits the federal government to share in the companies' marketing "profits" without having to participate in the market itself. This is not correct; the "duty to market" federal royalty oil, if the government chooses to receive royalty payments, has always been a requirement of lessees. The Interior Department's Board of Land Appeals (IBLA) has so ruled a number of times, citing a 1961 court action (California Co. V. Udall, 296 F.2nd, 387 D.C. Cir. 1961).

The most significant of the recent changes MMS made to the regulations proposed last January are:

- o If the lessee sells crude oil under a competitive call, gross proceeds for this sale may be used to compute royalties. A competitive call is one in which the buyer has a right to the oil, but at a price established competitively in the market.

- o If a lessee purchased oil from another company in the preceding 2-year period, the January regulations would have required use of the imputed (e.g., NYMEX-based) valuation for royalty payment. This has been deleted

- o The January proposal required use of the imputed valuation method for all oil exchanges. This has been changed to allow the lessee to use the gross proceeds from the sale of the oil received in the exchange as the basis for computing royalties (adjustments for location and oil quality are permitted). However, the imputed method must be used:

    - if the oil received in the exchange is exchanged again;
    - if the federal oil is transferred to an affiliate before the first exchange (this should not concern small independents that do not have separate trading affiliates);
    - if the oil received in exchange is subsequently transferred to an affiliate.

These changes effectively accommodate the small independent producers by allowing them to pay royalties on a "gross proceeds" basis—i.e., what they actually receive for their oil. It even allows them to do a small amount of trading.

Nevertheless, these changes hardly affect the large independents and the major integrated companies. That is, if the producing arm of a company transfers crude oil to the affiliated trading company, royalties must be paid using an imputed basis. This seems to affect most of the large independents and all the majors. However, note that this may not be as stringent as it sounds for smaller companies. If a corporation has a production division and a trading division, and they are both parts of the same company (not separate but affiliated companies), I believe that the rules could be interpreted to permit the company to pay royalties based on gross proceeds of a sale. But they could not shield profits from royalties in the trading division. It follows that the companies are not satisfied with the proposed changes.

What are the next steps for the companies? It seems obvious that, as long as the regulations are only "proposed," the companies can continue to pay on their old basis--so they will continue to seek extensions of the comment period and other delays. When there is no further course of action available, they will sue. At the same time, the larger companies are attempting to deal with a multitude of suits by States over the same underpayment problems. It is likely that their total potential exposure to claims made by States and other royalty recipients is much larger than it is to the U.S. Government. Clearly the companies would not want the Federal Government to recognize the nationwide underpayment problem formally by changing its royalty regulations while they are in the midst of fighting off other royalty holders. For this reason, we should not expect that any DOE comments that are only moderately supportive of the industry to help resolve this matter.

In light of the above observations, it seems that DOE's intervention on behalf of the companies and against MMS's new regulations would be prized by the companies, and might help MMS to decide to withdraw its proposal. As a matter of public policy, however, such an action should be out of the question.

Robert A.Speir

From: Bob SPEIR [Bob SPEIR at po-03] on behalf of Bob SPEIR
Sent: Friday, July 25, 1997 11:30 AM
To: JOHN NORTHINGTON
Subject: MMS Rules—Conversation with C. Quarterman

Questions for Kyle:

1. Any indication from smaller independents that they are content with the changes made that allow them to pay based on gross proceeds?
2. Are larger independents likely to continue to hold out for their suggested rules (which are very similar to the current rules that MMS proposes to change).
3. If MMS accepted the independents' counter proposal, MMS would either have to: a) accept what they say the oil is worth, b) obtain information on local market prices to check royalty payments, or 3) do more audits. Does it have the resources to do any of these?
4. Is MMS going to grant another delay and make additional changes? It is clear that the industry strategy is to delay as long as possible, then sue. Is the DOI prepared to defend against that suit aggressively?
5. Given that OMB would not allow MMS to collect location price differentials from companies (on the proposed MMS price form) what is the MMS plan to gather data to adjust NYMEX prices to represent wellhead values for Federal oil.
6. What is MMS doing to address the companies' demands that the Government take its oil in kind? Can it put its onshore (e.g., in Wyoming, North Dakota, etc.) oil together in large enough quantities to make it marketable? Can it get offshore oil to trading centers (e.g., St. James) cheaply, or would it have to pay exorbitant pipeline charges to move it to shore?
7. What are the plans for implementation? Is that the next step, or is there a trial period to test the new regs?

6.

21

Royalty Valuation of Crude Oil: Options to Poste

Issue: Should the MMS alter its royalty valuation procedures for crud from Federal lands to eliminate posted prices as a measure of v

Options:
(1) Measure value by reference to NYMEX closing prices.
(2) Measure value by reference to spot prices for a marker crude.
(3) Measure value by reference to a market basket of crudes.
(4) Continue to use a gross proceeds approach, but require independently audited annual statements be submitted certifying accuracy. The auditing firm would share financial responsibility for under payments.
(5) Continue current practice of accepting posted price as a measure of value.

Recommendation: Because crude markets differ geographically, a combination of options (1) through (4) should be used to value crude oil for royalty purposes. Different crude markets may require different measures. Since the States recognize the problems posed by reliance on posted prices and have already started to move to other basis, MMS should take advantage of the State experiences. Basing the approach on State methods will also simplify compliance for industry.

Regardless of the measure(s) selected MMS should require lessees to submit independently audited annual statements, by an MMS approved firm, certifying royalties have been paid on all receipts attributed to the production of crude according to the measure of value selected. To further ensure the reliability of these private audits, the auditing firm should share financial responsibility for under payments. In addition to helping to solve the underpayment problem, requiring audited annual statements should significantly reduce the need for and cost of a Federal audit program.

Global settlements, if they proceed, should explicitly preserve the valuation issue.

Magnitude of Under Collections: An interagency task force formed to examine the magnitude of under collections in California has estimated that the under payments have exceeded $850 million since 1978 alone. The recent settlement with the State of Alaska, for the years 1977 - 1991, was more than $3 billion in taxes and royalties, with royalties representing between $800 - $900 million. The Department of Energy has estimated that the continuing short-fall, exclusive of Alaska and California, is in excess of $80 million annually, exclusive of interest. An industry consultant who has been working with the States to address the undervaluation issue estimates the undervaluation as between 3 and 10 percent of annual revenues. Based on total annual oil royalty collections of about $1 billion, total under collections would range from $33 million to $100 million annually.

Work in progress, June 17, 1996.

State Position(s): States have recognized the problems posed by reliance on posted prices for several years, and are currently in various stages of (1) settlement or litigation relative to prior under payments; and (2) modifying procedures or valuation bases to avoid problems in the future. Those States who also share royalty revenues from production on Federal lands are requesting changes in Federal procedures.

Industry Position(s): Some large companies have voluntarily initiated settlements with State and private royalty owners to pay the difference in royalties between the royalties paid in the past based on posted prices, and royalties based on what the company actually received, plus interest and penalties. No such offers appear to have been extended to the Federal government. Other large, integrated producers (as well as their trade associations) have declined to comment due to the current litigation by State and private royalty owners relating to under payments based on posted prices. Small, independent producers have expressed concern that valuation based on something other than posted prices could result in a requirement to pay royalties on "phantom revenues"-- the difference between the measure of market value and the posted price they may be forced to accept.

Current Status: On December 20, 1995, MMS issued an Advance Notice of Proposed Rulemaking requesting comments on the use of posted prices.

Background

Most Federal leases provide that a royalty be paid on the amount or value of the oil produced from or attributable to Federal lands. The value of production is defined by the Secretary of the Interior in regulation to correspond to the market value of the production. The regulations also provide that value can never be *less* than the gross proceeds from the sale of the production in an arm's length transaction. When oil is refined by an affiliate of the production company, the posted price in the field is typically used as the measure of market value if arm's length transactions are also conducted at the posted price. However, there is a virtual consensus among royalty owners, outside the Federal government, that posted prices may *not* represent market value, even in apparent arm's-length transactions, and hence are not a particularly good basis for determining royalty and may lead to consistent and significant under payment[1].

[1] This paper does not address the consistency of the current regulations with collecting royalty on a basis of market value, nor whether a regulatory change is required to ensure that this is the case. That determination must be made by the Solicitor. The purpose of this paper is to explain why posted prices are *not* an appropriate measure, and to identify approaches that are appropriate to measuring market value.

Work in progress, June 17, 1996.

Simply stated, posted prices are the result of management decisions not the result of market transactions and thus, although they may be responsive to changes in market values, there is no reason to believe they will correspond to market values. Posted prices may be most easily understood by comparison to the "sticker price" on a car. Particularly if a refiner purchases a large portion of its crude in the open market, and knows it must negotiate for the best price, the difference between the actual market value and the posted price may be substantial. The negotiated arm's-length price will reflect a premium or bonus paid in addition to the posting. This is commonly referred to as p+. Prices in the p+ market may vary daily with changes in the futures market, and are published daily along with the prices changes in the futures market.

A common transaction in the industry is known as a buy/sell. In a buy/sell, purchases and sales of like or similar quality crudes are simultaneously bought and sold by a company, often as a method of transporting the crude from one location to another. A differential in price is typically assumed to be a location differential, and often deducted from the final sale price, as a transportation cost allowance, under MMS regulations, to arrive at the value for Federal royalty purposes. This type of transaction, even if between "unrelated parties of opposing economic interest" is not price sensitive, and thus cannot be considered as reflecting market value. Specifically, neither the buyer nor the seller in a buy/sell has any interest in the price at either the buy or the sell points in the transaction. The attention is focused only on the price differential. Thus a transaction booked at a $8 buy and a $10 sell could just as easily have taken place at a $16 buy and $18 sell, or $4 buy and $6 sell. Since the only economic content to the transaction is the difference in the buy and sell prices, no inference to market value may be drawn from this transaction for royalty purposes. Thus a buy/sell based on postings is not evidence that the posting is the market value.

Similar to the buy/sell is the exchange. This is simply an exchange of one crude for another, where locations and/or qualities of the crudes exchanged may differ. As in the case of the buy/sell, the only economic content to the transaction is the location and/or quality differentials. The "value" at which the transaction is carried on the books cannot be interpreted as a market value. Thus, again, an exchange based on postings is not evidence that the posting is the market value, even if between "unrelated parties of opposing economic interest."

To illustrate the problem, and its complexity, assume that the fair market value of a barrel of crude is $20 in the field and $21 at market in Cushing, Oklahoma where NYMEX settlements are based. The $1 difference is a location differential. The producer may sell its crude to an unrelated buyer for $16 in the field, exchanging it for crude in Cushing at $17. The buyer is, of course, indifferent since the $4 loss realized in Cushing ($21 - $17) to make the exchange is offset by the additional $4 profit in the field ($20 - $16). This type of transaction is not uncommon even when the buyer is a refiner located near the field, where the appearance is that the purchase is a simple purchase of crude to be refined.

A further complicating factor may include the addition of more parties to the transaction. Instead of the bilateral transaction just described, the transaction may involve three or four "economically unrelated" parties. Such multi-party transactions would make audits extremely difficult.

A additional complicating factor in trying to infer value from posted prices is the manner in which oil properties may be bought and sold. Sales and farm-out agreements, usually between large integrated companies and independents, often contain a "call" provision. The "call" clause allows the seller of the property to call on the production from the buyer at posted prices. This is effectively a financing mechanism allowing the independent purchaser to buy a property it otherwise could not afford. It significantly complicates the task of trying to relate posted prices to market value, however, since it may be necessary to analyze real estate transactions to determine if fair market value was obtained in apparent cash transactions between "unrelated parties of opposing economic interest." That is, fair market value can only be inferred from transactions between willing but not obligated buyers and sellers of opposing economic interest; and one cannot assume unobligated sellers because of the "call" provision in the real estate transaction.

The complications described are an artifact of a focus on the market transactions rather than on the market value. The common thread in the transactions is that they ultimately result in some type of exchange at a market center, usually Cushing, but St. James, La. or other recognized market. This market reference is important to the parties to assure themselves of the value. Thus the determination of market value may be simplified by focusing directly on the value at the market center, and adjusting for the known location and/or quality differentials.

Work in progress, June 17, 1996.

Valuation Based On NYMEX Closing Prices

Valuation Based on Marker Crude Spot Prices

Valuation Based on Reference to Market Baskets

Continued Reliance on Posted Prices

Work in progress, June 17, 1996.